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Neil E. Harl
Iowa State University

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Discharge of Indebtedness--
A Source of Surprises: Part I

- by Neil E. Harl*

Lower grain and soybean prices have brought back memories (for many) of the 1980s.¹
One of the early issues encountered with reduced incomes is discharge of indebtedness.²
The rules governing discharge of farm indebtedness differ significantly from the rules on discharge of indebtedness generally.³

This article focuses on the general rules on discharge of indebtedness. The next issue will cover discharge of indebtedness for farm taxpayers.

The general rules on discharge of indebtedness

In general, if indebtedness is cancelled or forgiven, the amount cancelled or forgiven is ordinary income and must be included in gross income.⁴ Cancellation of accrued interest (unless deducted by the taxpayer on the accrual method of accounting) is of no income tax consequence since the receipt of interest income is offset by a deduction of interest expense. However, that rule does not apply if the exception in I.R.C. § 108(e)(2) is applicable.⁵

What is gain or loss on the property and what is discharge of indebtedness? Forgiveness of principal does have income tax consequences. In general, amounts above the income tax basis and up to the fair market value are treated as gain or loss on the property. I.R.C. § 108, which provides relief for discharge of indebtedness, does not apply to gain realized on the transfer of the property.⁶ Amounts above fair market value and up to the amount of the debt are discharge of indebtedness.

When discharge of indebtedness occurs. If no objections are sustained, for those in Chapter 7 (liquidation bankruptcy), discharge of indebtedness occurs 60 days after the meeting of creditors at which the debtor appears and can be examined.⁷ Under Chapter 11 bankruptcy, discharge of indebtedness occurs upon confirmation of the plan of reorganization as to debts arising before confirmation with some exceptions.⁸ Under Chapter 12 (farm bankruptcy) the discharge is to take place “as soon as practicable” after completion of payments under the plan.⁹ For Chapter 13 bankruptcy, discharge occurs upon completion of payments under the plan.

In a foreclosure action, discharge of indebtedness occurs when all appeals of the action have been exhausted.¹⁰

Discharge of indebtedness intended as a gift. One exception to recognition of discharge of indebtedness as taxable income is where the discharge was intended as a gift.¹¹ However, that exception is very limited, as might be expected.¹²

* Charles F. Curtiss Distinguished Professor in Agriculture and Emeritus Professor of Economics, Iowa State University; member of the Iowa Bar.
**The exceptions to the general rule**

There are currently five exceptions to the general rule that discharge of indebtedness must be included in the debtor’s gross income.\(^{13}\)

**Debtors in bankruptcy.** Indebtedness discharged in bankruptcy is not included in the debtor’s income.\(^{14}\) Bankruptcy, for this purpose, includes Chapter 12 bankruptcy for farmers.\(^{15}\) Rather, the cancelled indebtedness leads to reduction in the income tax basis of the debtor’s property or other “tax attributes” are reduced or both\(^{16}\) if the taxpayer is under the jurisdiction of the court and the discharge is granted by the court or is pursuant to a plan approved by the court. It is not important for income tax purposes whether the taxpayer is solvent or insolvent.

Some taxes as debts of the bankruptcy estate are not dischargeable\(^{17}\) including taxes which are an eighth priority claim in the bankruptcy estate, income taxes and penalties for taxable years ending on or before the date of bankruptcy filing, income taxes requiring returns to be filed within three years of bankruptcy filing, and income taxes for the “first short year” if the debtor has elected to terminate the debtor’s taxable year as of the day before the day of bankruptcy filing.\(^{18}\)

**Adjusting tax attributes.** The bankruptcy estate receives the tax attributes of the debtor as of the beginning of the tax year in which bankruptcy is filed if the debtor chooses to retain a single tax year.\(^{19}\) In the event the taxpayer elects two short years, the first ending the day before bankruptcy filing, the tax attributes do not pass to the bankrupt estate until the beginning of the second short year which runs until the end of that year.\(^{20}\) That means the debtor can apply the tax attributes on the debtor’s income tax return for the first short year.

Here’s the order of adjustment of tax attributes – (1) any net operating loss for the tax year in which indebtedness is cancelled is reduced first and the same applies to any net operating loss carried forward to that year with the current year’s net operating loss applied first;\(^{21}\) (2) any carryovers to or from the taxable year of discharge of research credits\(^{22}\) and general business credits;\(^{23}\) (3) minimum tax credits;\(^{24}\) (4) the current year’s net capital loss first and then capital loss carryover; (5) the income tax basis of the debtor’s property;\(^{25}\) (6) any passive activity loss or credit carryover from the taxable year of the discharge;\(^{26}\) and (6) foreign tax credits.\(^{27}\)

An election can be made to first reduce the basis of part or all of the depreciable property.\(^{28}\) If that election is made, the basis can be reduced to zero.\(^{29}\)

**Discharge of indebtedness of an insolvent taxpayer outside of bankruptcy.** As a general rule, the cancellation of indebtedness for taxpayers not in bankruptcy produces income. However, income from the discharge of indebtedness for an insolvent taxpayer is excluded from income to the extent of the insolvency.\(^{30}\) Exempt property was not included in the insolvency calculations until 1999 when IRS issued a private letter ruling changing its position and specifying that exempt property was properly included in assets for purposes of determining insolvency.\(^{31}\)

**Discharge of real property business debt.** For discharges of indebtedness occurring after 1992, taxpayers other than C corporations may elect to exclude from gross income amounts realized from the discharge of “qualified real property business indebtedness.”\(^{32}\) The term does not include qualified farm indebtedness, however.\(^{33}\)

In the next issue, the discussion is on discharge of farm indebtedness and purchase price adjustment.

**ENDNOTES**

2. I.R.C. §§ 108(a)(1)(C), 108(g).
4. I.R.C. § 61(a)(12). See, e.g., Vukasovich, Inc. v. Comm’r, 790 F.2d 1409 (9th Cir. 1986), aff’d in part and rev’d in part, T.C. Memo. 1984-611 (cancellation of indebtedness for less than amount owed resulted in ordinary income to the debtor). See also Mas One Limited Partnership v. United States, 390 F.3d 427 (6th Cir. 2004) (limited partnership required to recognize discharge of indebtedness income when former sole limited partner paid remaining principal balance of bank loan to obtain release).
5. Brooks v. Comm’r, T.C. Memo. 2012-25 (deduction of investment interest is limited to net investment income).
6. See Gehl v. Comm’r, 95-1 U.S. Tax Cas. (CCH) ¶ 50,191 (8th Cir. 1995) (gain from disposition of assets cannot be excluded under the insolvency exception; no discharge of indebtedness).
10. See Ryan v. Comm’r, T.C. Memo. 1988-12, aff’d, 873 F.2d 194 (8th Cir. 1989) (accrual basis limited partners realized income from discharge of indebtedness in taxable year appeal of foreclosure action completed and not the year of foreclosure sale).
12. See DiLaura v.. Comm’r, T.C. Memo. 1987-291 (no evidence gift intended on discharge of indebtedness).
15. Ltr. Rul. 8928012, April 7, 1989 (debtor considered “in bankruptcy” for purposes of discharge of indebtedness).
19. I.R.C. § 1398(g).
20. *Id.*
policies not codified in the Code of Federal Regulations that are identical to those in the Common Crop Insurance Basic Provisions (Basic Provisions) or Crop Provisions codified in the Code of Federal Regulations. In such instances, the requestor sought an interpretation of the applicable provision in the Basic Provisions and that interpretation was applicable to all policies that contained an identical provision. Nothing in this rule changes this process. However, there are numerous policies with provisions that are not codified in the Code of Federal Regulations in any policy. For these policy provisions, this rule provides a mechanism to obtain an interpretation of such provision. The proposed regulations also incorporate the information formerly contained in Manager’s Bulletin MGR-05-018 into subpart X for efficiency and ease of use. Manager’s Bulletin MGR-05-018 currently provides criteria for requesting an interpretation of procedures when a requestor seeks an interpretation of the meaning or applicability of procedure used in administering the Federal crop insurance program. 80 Fed. Reg. 14030 (March 18, 2015).

GIFTS. The taxpayer created an irrevocable trust for the benefit

CASES, REGULATIONS AND STATUTES
by Robert P. Achenbach, Jr

BANKRUPTCY

CHAPTER 12

DISCHARGE INJUNCTION. The debtors, husband and wife, had originally filed under Chapter 7 and the claims included five bank loans secured by the debtor’s residence. The debtors received a discharge but later moved to convert the case to Chapter 12. The bank agreed to a restructuring of the mortgages which included an assignment of milk sales proceeds to the bank. Although early payments were sufficient, payments later in the year fell short of the agreed amount and the agreement was terminated by the debtors. The bank then began foreclosure proceedings against the residence and the debtors filed a contempt motion alleging that the foreclosure violated the discharge injunction and that the milk proceeds paid to that date were involuntary payments. Under Section 524(j), a creditor is exempt from the discharge injunction if “(1) such creditor retains a security interest in real property that is the principal residence of the debtor; (2) such act is in the ordinary course of business between the creditor and the debtor; and (3) such act is limited to seeking or obtaining periodic payments associated with a valid security interest in lieu of pursuit of in rem relief to enforce the lien.” The court held that the bank was allowed under Section 524(j) to seek foreclosure because the milk proceeds agreement met all three conditions. In re Teal, 2015 U.S. Dist. LEXIS 32315 (E.D. Tenn. 2015).

FEDERAL FARM PROGRAMS

CROP INSURANCE. The FCIC has issued proposed regulations which revise the General and Administrative Regulations Subpart X--Interpretations of Statutory and Regulatory Provisions to provide requestors with information on how to request a final agency determination and locate the interpretation of procedures or policy provisions not codified in the Code of Federal Regulations within one administrative regulation. There are provisions in

FEDERAL ESTATE AND GIFT TAXATION

GENERATION SKIPPING TRANSFER TAX. Two irrevocable trusts were formed by a husband and wife prior to September 25, 1985 and each trust owned a parcel of contiguous farmland. The current beneficiaries were descendants of the grantors of the trusts. The two parcels were acquired at different times and one was landlocked by the other parcel. The trustees of the two trusts decided to sell the two parcels as one unit to avoid having to sell one parcel as land locked. The land was purchased by a limited partnership owned by a lineal descendant of the original grantors and was trustee of one of the trusts and a contingent beneficiary of the other trust. The sale was negotiated by attorneys for the trusts and buyer. The IRS ruled that the sale of the farmland did not subject the trusts to GSTT because the sale did not change any of the beneficial interests in the trust and the sale was made at arm’s length. Ltr. Rul. 201510009 through 201510016, Oct. 16, 2014; 201511002 through 201511010, Oct. 16, 2014.

GIFTS. The taxpayer created an irrevocable trust for the benefit

22 I.R.C. § 30.
28 I.R.C. § 108(b)(5).
29 See I.R.C. § 1017(b)(2).
32 I.R.C. § 108(c).
33 I.R.C. § 108(c)(3).